

[Senate Bill 591](#) (Pan)

Date: 06/02/2015

Program: Cigarette and Tobacco Products Tax

Sponsor: Author

RTC Sections 30104, 30108, 30181, and Article 2.5 (commencing with Section 30130.50)

Effective January 1, 2016.

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***This analysis only addresses the provisions that impact the Board of Equalization (BOE).***

**Summary:** Among other things, imposes a new \$2 per pack cigarette tax, an equivalent floor stock tax,<sup>1</sup> and indirectly increases the tobacco products tax.

**Summary of Amendments:** The amendments since the previous analysis add distribution percentages to the fund allocations provisions.

**Purpose:** To decrease smoking rates, improve access to health care, and advance California's tobacco prevention and control programs.

**Fiscal Impact Summary:** \$665.2 million and \$1.290 billion for the California Tobacco Tax Act of 2015 Fund for fiscal year 2015-16 and 2016-17, respectively.

**Existing Law: Cigarette and Tobacco Products Tax Law.** Existing law imposes an \$0.87 per package of 20 (43 ½ mills per cigarette) cigarette tax. The cigarette tax components and the revenue disposition are as follows:

- \$0.10 per pack (5 mills per cigarette) is allocated to the General Fund (Sections 30101 and 30462 of the Revenue and Taxation Code (RTC));
- \$0.02 per pack (1 mil per cigarette) is allocated to the Breast Cancer Fund (RTC Sections 30101 and 30461.6);
- \$0.25 per pack (12 ½ mills per cigarette) is allocated to the Cigarette and Tobacco Products Surtax Fund (RTC Sections 30122 and 30123); and
- \$0.50 per pack (25 mills per cigarette) is allocated to the California Children and Families (CCF) Trust Fund (RTC Sections 30131.2 and 30131.3).

RTC Section 30123 imposes a tax upon the distribution of tobacco products, based on the wholesale cost of these products at a tax rate that is equivalent to the combined rate of tax imposed on cigarettes. In addition, Section 30131.2 imposes an additional tobacco products tax at a rate equivalent to the \$0.50 per pack cigarette tax. The BOE determines the tobacco products tax rate annually based on the March 1 wholesale cost of cigarettes. The 2014-15 tobacco products rate is 28.95%.

The Board of Equalization (BOE) deposits the tobacco products surtax imposed under Section 30123 into the Cigarette and Tobacco Products Surtax Fund (including any revenues that result from an indirect increase in the tobacco products tax triggered by a cigarette tax increase). The BOE deposits the tobacco products surtax imposed under Section 30131.2 into the CCF Trust Fund.

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<sup>1</sup> A floor stock tax is a one-time tax on all tax-paid (stamped) cigarettes and unaffixed tax stamps in the possession of distributors, wholesalers and/or retailers on the effective date of a cigarette and tobacco products tax increase. The floor stock tax rate is the difference between the old tax rate and the new tax rate.

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**Proposition 10 Backfill.** Health and Safety Code (HSC) Section 130105<sup>2</sup> requires the BOE annually to determine the revenue reductions to any Proposition 99 state health-related education and research programs and the Breast Cancer Fund that result directly from Proposition 10's additional taxes. These reductions may result from reduced consumption or increased black market activity due to the increased tax. HSC Section 130105 also requires funds to be transferred from the CCF Trust Fund to affected programs to offset these revenue reductions.

**Cigarette and Tobacco Products Licensing Act<sup>3</sup> (Licensing Act).** The Licensing Act requires the BOE to administer a statewide program to license cigarette and tobacco products manufacturers, importers, distributors, wholesalers, and retailers. Business and Professions Code (BPC) Section 22970.1 includes legislative findings and declarations that state "tax revenues have declined by hundreds of millions of dollars per year due, in part, to unlawful distributions and untaxed sales of cigarettes and tobacco products conducted by organized crime syndicates, street gangs, and international terrorist groups." Section 22970.1 further provides that "the licensing of manufacturers, importers, wholesalers, distributors, and retailers will help stem the tide of untaxed distributions and illegal sales of cigarette and tobacco products."

**Proposed Law: Cigarette Tax Increase.** This measure enacts **The California Tobacco Act of 2015<sup>4</sup>** (Tobacco Act) to impose an additional cigarette tax at a rate of \$2 per package of 20. The Tobacco Act imposes the additional cigarette tax on and after January 1, 2016.

**Floor Stock Tax.** This measure also imposes a compensating floor stock tax on every dealer (retailer) and wholesaler for each cigarette in his or her possession or control at 12:01 a.m. on January 1, 2016. In addition, this measure imposes upon every licensed distributor a cigarette indicia adjustment tax on affixed and unaffixed cigarette tax stamp inventory at 12:01 a.m. on January 1, 2016. The floor stock tax return and tax would be due to the BOE on or before July 1, 2016.

**Fiscal Provisions.** Except for payments of refunds and backfill transfers, the BOE would deposit all revenues in the newly created Tobacco Tax Fund, which this measure creates in the State Treasury. The Tobacco Tax Fund is established as a trust fund, with amounts transferred to the Tobacco Prevention and Education Account (14%), Tobacco Disease Related Health Care Account (84%), and Tobacco Law Enforcement Account (2%), which this bill creates in the Tobacco Tax Fund.

**Cigarette and Tobacco Products Tax.** This bill amends several sections within the Cigarette and Tobacco Products Tax Law to add conforming and necessary code section references that allow the BOE to properly administer the surtax in a manner consistent with the existing cigarette and tobacco products tax.

**Operative Date.** The bill becomes effective January 1, 2016; however, the act becomes operative only if [Assembly Bill 1396](#) (Bonta) is also enacted and takes effect on or before January 1, 2016.

**Background:** Proposition 99, approved by voters in November 1988 and effective January 1, 1989, imposed a surtax of \$0.25 per package of cigarettes, and also created an equivalent tax on other tobacco products. Tax proceeds provide funding for health education, disease research, hospital care, fire prevention, and environmental conservation.

Assembly Bill 478 (Ch. 660, 1993) and Assembly Bill 2055 (Ch. 661, 1993), effective January 1, 1994, added an excise tax of \$0.02 per package of cigarettes for breast cancer research and early detection services.

Proposition 10, approved by voters in November 1998 and effective January 1, 1999, imposed an additional surtax of \$0.50 per package of cigarettes. Additionally, the measure imposed an additional excise tax on the distribution of tobacco products equivalent to the additional cigarette tax and imposed

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<sup>2</sup> Added by Proposition 10.

<sup>3</sup> Division 8.6 (commencing with Section 22970) of the Business and Professions Code (BPC).

<sup>4</sup> Article 2.5 (commencing with Section 30130.50) of Chapter 2 of Part 13 of Division 2 of the RTC.

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an equivalent compensating floor stock tax. The additional tax revenues are deposited into the CCF Trust Fund and used to fund early childhood development programs, and to offset any revenue losses to certain Proposition 99 programs resulting from the Proposition 10 tax increase.

### Commentary:

1. **The June 2, 2015 amendments** add the transfer allocation percentage for moneys in the Tobacco Tax Fund and make technical, non-substantive corrections. These amendments do not impact the BOE. The **April 16, 2016 amendments** (1) revised the operative date for the additional cigarette tax and due date for the floor stock tax to January 1, 2016 and July 1, 2016, respectively; (2) deleted the backfill provisions; (3) removed the revenue allocation provisions that provide the BOE additional enforcement funding; and (4) allowed the bill to become operative only if Assembly Bill 1396 is enacted and takes effect on or before January 1, 2016.
2. **Indirect tobacco products rate increase.** This measure does not directly increase the tobacco products tax; however, existing law triggers an automatic tobacco products tax increase whenever the cigarette tax is increased.<sup>5</sup> Specifically, Section 30123(b), as added by Proposition 99, generally requires the BOE to annually determine the tobacco products tax rate at a rate *equivalent to the combined rate of all taxes imposed on cigarettes*.

Additionally, existing law directs the BOE to deposit these indirect tobacco products tax proceeds into the Cigarette and Tobacco Products Surtax Fund (Proposition 99) to fund health education, disease research, hospital care, fire prevention, and environmental conservation.

3. **Indirect tobacco products increase effective date.** Existing law requires the BOE to annually determine the tobacco products tax rate. As discussed in Comment 1, the \$2.00 per pack cigarette tax increase indirectly increases the tobacco products tax rate as a result of Proposition 99.

With respect to the tobacco products rate determination, existing law requires:

- The BOE to annually determine the tobacco products rate;
- The BOE to base the rate on the wholesale cost of tobacco products as of March 1; and
- The determined tobacco products rate to be effective during the state's next fiscal year.

Consequently, the BOE's rate determination must occur no earlier than March 1, but no later than June 30, each year to be effective for the next fiscal year. Accordingly, the 2016-17 tobacco products rate determination would include the proposed tax, effective July 1, 2016.

4. **Administrative start-up cost funding is essential.** The bill imposes an additional cigarette tax on and after January 1, 2016. As a result, the BOE must begin to implement the bill in fiscal year 2015-16. However, the BOE's 2015-16 budget does not include funding to implement the bill. Consequently, the BOE requires an adequate appropriation to cover administrative implementation costs.

Typically, the BOE seeks administrative cost reimbursement from the account or fund into which tax proceeds are deposited. However, this bill creates the Tobacco Tax Fund, which lacks funding to reimburse the BOE prior to collection of the tax. Upfront BOE implementation cost reimbursement is essential. Thus, BOE staff suggests the bill authorize a loan from the General Fund (GF) or other eligible fund to the Fund. The loan would be repaid from taxes collected.

Constitutional and statutory provisions prohibit the BOE from using special fund appropriations to support the administration of the proposed cigarette tax increase. Without an appropriation, it may be necessary for the BOE to divert GF dollars to implement the proposed tax program. A GF

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<sup>5</sup> Imposed under the Cigarette and Tobacco Products Tax Law.

diversion typically results in a negative impact on GF-supported programs and related State and local government revenues.

5. **Delayed operative date necessary.** To effectively implement this bill, the BOE must: notify taxpayers; develop computer programs; hire and train key staff; change the cigarette tax stamp design and denomination; create and revise necessary forms and schedules; and answer taxpayer inquiries. These functions must take place before the tax becomes operative. The current effective date of January 1, 2016, is insufficient. BOE staff estimates the additional cigarette tax and floor stock tax implementation to take a minimum of six months. Accordingly, the BOE staff recommends an amendment to provide an operative date on and after the first day of the first calendar quarter commencing more than 90 days after the effective date of the bill.
6. **Floor stock tax provisions.** The bill contains language to impose a floor stock tax on the cigarette inventory of every dealer (retailer) and wholesaler, and affixed and unaffixed cigarette tax stamp inventory of a distributor. A floor stock tax imposes a one-time tax on all tax-paid (fixed stamp) cigarettes and unaffixed tax stamps in the possession of distributors, wholesalers and/or retailers on the effective date of a cigarette tax increase. The floor stock tax rate is the difference between the old tax rate and the new tax rate. Generally, a measure imposes a floor stock tax to equalize the excise tax paid by cigarette retailers, wholesalers, or distributors on their inventory and those cigarettes purchased after the effective date of a tax increase.

Without a floor stock tax, a cigarette seller could purchase a large amount of cigarettes before the tax rate increase takes effect. That seller could then sell those cigarettes at a higher price and attributable the higher selling price to the tax increase. The higher selling price in this case represents a windfall profit to the seller rather than excise taxes paid to the state since the cigarettes were purchased at the prior (and lower) tax rate. A floor stock tax mitigates this windfall profit. This measure contains a floor stock tax on cigarettes only, and not tobacco products.

While the BOE incurs additional costs to administer the floor stock tax, these costs would be offset by the tax proceeds.

7. **Tax evasion.** Tax evasion reduces state revenues that cigarettes and other tobacco products taxes generate. BOE staff estimates that cigarette tax evasion in California runs at a rate of approximately \$126 million, along with \$88 million in tax on other tobacco products.<sup>6</sup>

During the mid-1990s, the BOE's cigarette tax evasion estimates remained stable since cigarette prices and excise taxes were fairly constant during that time. However, since November 1998, two major events dramatically increased California excise taxes as well as cigarette prices (excluding taxes): Proposition 10 and the Tobacco Master Settlement Agreement between states and tobacco manufacturers (tobacco settlement). These two developments, coupled with typical wholesaler and retailer distribution margins, coincided with approximately a 50% increase in the average prices of cigarettes to California consumers compared to early November 1998 prices. According to BOE estimates, the impacts of Proposition 10 and the tobacco settlement more than doubled the dollar amount of cigarette tax evasion in California.

Since 1998, many new measures have reduced cigarette and other tobacco products tax evasion. These include the Licensing Act, an encrypted cigarette tax stamp, and the Prevent All Cigarette Trafficking Act (PACT Act).

The substantial cigarette tax imposed by this bill will result in an increase in the retail price of cigarette and tobacco products to the extent that the tax increase is passed along to consumers. Based on historical data related to Proposition 10 and the tobacco settlement, and research of similar experiences in other states, along with research of other states' experiences, BOE staff believes the proposed cigarette tax increase and resulting increase in the tobacco products tax could

<sup>6</sup> <http://www.boe.ca.gov/legdiv/pdf/CigaretteEvasion.pdf>.

result in both a decrease in actual consumption and an increase in tax evasion. The exact magnitude of these variables is uncertain since the proposed excise tax increase is significantly greater than prior tax increases.

8. **Increase in state and local sales and use tax revenues.** The total retail sales price of tangible personal property is subject to the sales or use tax, unless specifically exempted or excluded by law. Since the proposed cigarette tax increase and indirect tobacco products tax is not specifically exempted or excluded, it would be included in the total sales price and, therefore, subject to sales or use tax.

To be reimbursed for the proposed new taxes, a distributor, wholesaler, or retailer would likely incorporate the additional taxes into the sales price of the cigarettes and tobacco products sold to other licensees or consumers. The Revenue Estimate discusses the impact on state and local sales and use tax revenues.

9. **Distributor discount.** RTC Section 30166 requires stamps and meter impression settings to be sold to licensed distributors at their denominated values less 0.85%. The discount helps defray the distributor's cost (leasing of equipment/labor cost) for affixing the stamps to cigarette packages.

Currently, distributors receive a discount of \$221.85 [(30,000 stamps x \$0.87 tax per package of cigarettes) x 0.85% discount = \$221.85 discount] per roll of 30,000 cigarette tax stamps. A \$2.87 excise tax on a package of cigarettes increases the distributors' discount to \$731.85 [(30,000 stamps x \$2.87 tax per package of cigarettes) x 0.85% discount = \$731.85 discount] per roll of 30,000 stamps.

10. **Licensing Act funding.** In 2003, Assembly Bill 71 (J. Horton, Ch. 890) enacted the Licensing Act, which established a statewide licensure program administered by the BOE to help stem the tide of untaxed distributions and illegal sales of cigarettes and tobacco products. Currently, the BOE licenses 35,000 retailers and 900 distributors and wholesalers to engage in the sale of cigarettes and tobacco products in California.

As Assembly Bill 71 made its way through the Legislature, revenue projections indicated that revenue beyond the licensure fees would be needed to sustain the Licensing Act program. Since the Licensing Act enforces the CTPTL and directly benefits the funds established pursuant to that program, the bill was amended to require that the cigarette and tobacco products tax funds<sup>7</sup> cover the difference between the amount received in licensure fees and the funds needed for the program. Specifically, the uncoded language provides:

All revenues and expenses generated by this act with respect to the taxes imposed under the Cigarette and Tobacco Products Tax Law (Part 13 (commencing with Section 30001) of Division 2 of the Revenue and Taxation Code), shall be allocated in the same manner as those revenues and expenses are allocated under the Cigarette and Tobacco Products Tax Law **as that law read on the effective date of this act.**

It does not appear that the tax revenues generated by this bill could be used to reimburse the BOE's Licensing Act administrative costs because the tax proposed in this bill was not effective on the date of the Licensing Act.

It should be noted that AB 1396 (Bonta) appropriates Tobacco Law Enforcement funds to the BOE, the Department of Justice, and the State Department of Public Health "for the purpose of supplementing funding for enforcement of laws that regulate the distribution and sale of cigarettes and other tobacco products."

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<sup>7</sup> General Fund, Breast Cancer Fund, Cigarette and Tobacco Products Surtax Fund (Prop. 99) and California Children and Families Trust Fund (Prop. 10).

11. **Related legislation.** [AB 1396](#) (Bonta) contains provisions applicable to this bill. These provisions include the BOE requirement to determine the effect of the additional cigarette tax and indirect tobacco products tax on cigarette and tobacco products consumption and to backfill the existing cigarette tax funds to offset the revenue decrease resulting from this measure's additional cigarette and indirect tobacco products tax increase. That bill also requires funds in the Tobacco Law Enforcement Account to be made available to the BOE, the Department of Justice, and the State Department of Public for enhanced cigarette and tobacco products law enforcement.

**Administrative Costs:** BOE administrative costs related to this bill are substantial. These costs include: taxpayer notification, tax return design, computer programming, cigarette tax stamp design and denomination changes, compliance and audit efforts to ensure proper reporting, and floor stock tax administration.

Furthermore, the bill requires enhanced efforts to ensure proper floor stock tax reporting and collection, greater compliance efforts for additional billings and delinquencies, and an increase in BOE program and audit and investigative staff presence due to increased tax evasion.

## Revenue Impact:

### Background, Methodology, and Assumptions

**Fiscal Year 2015-16 Impacts.** Since this bill is effective January 1, 2016, the revenue impact in FY 2015-16 will be about half of the revenue impact under a complete fiscal year. This bill includes a corresponding floor stock tax imposed on inventories on January 1, 2016. Staff assumes a three-week supply of cigarettes would be subject to the floor stock tax, based on a combination of expected sales rates before and after the tax takes effect. Since the due date for the floor stock tax is July 1, 2016, we assume all floor stock tax revenues are received in FY 2015-16.

**Cigarette Tax.** In FY 2013-14, 871 million tax-paid cigarette packs were distributed. Since 1980, tax-paid distributions have decreased about 3% per year. Staff believes that the 3% annual decline represents a reasonable estimate of the underlying trend for future years. This trend shows no clear signs of abating; thus, tax-paid cigarette distributions will likely decline by about 3% annually for FY 2014-15 and future years absent federal or state law changes.

Based on previous tax increases, academic studies, and research of experience in other states, staff believes a tax rate increase as sizeable as proposed by this bill likely would cause both a decrease in actual consumption and an increase in tax evasion. Although the exact magnitude of the split between evasion and consumption is uncertain, staff estimates tax-paid distributions to decrease by 19%. This estimate uses a price elasticity of demand of -0.70 calculated by the arc price elasticity formula, applied to an average estimated November 1, 2015, price of approximately \$5.74 per pack.<sup>8</sup>

**Tobacco Products Tax.** Pursuant to Proposition 99, this measure would result in an additional tobacco products tax equivalent to the new \$2 per pack imposed on cigarettes. The BOE sets the tobacco tax rate prior to the start of each fiscal year using wholesale cost data available as of March 1. In recent years, the BOE has set the rate for the upcoming fiscal year in April or May. FY 2016-17 would be the first year the tobacco tax rate calculations would include the proposed tax rate increase.

The tobacco products tax is based on the wholesale cost of these products at a tax rate equivalent to the tax rate imposed on cigarettes. The rate is determined by dividing the tax rate per cigarette by the average wholesale cost per cigarette. In recent years, wholesale costs of cigarettes have risen, which results in rate declines since the total California excise tax on cigarettes has been constant since 1999. The BOE set the rate for FY 2014-15 at 28.95%. FY 2016-17 would be the first fiscal year affected by this

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<sup>8</sup> The general price elasticity of demand formula is:  $e_p = (Q_1 - Q_2) / ((Q_1 + Q_2) / 2) / (P_1 - P_2) / ((P_1 + P_2) / 2)$ , where P = price and Q = sales.

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measure. Staff estimates that, with the additional \$2 per pack tax, the tobacco products tax rate in FY 2016-17 would be 64.72%.

The wholesale cost (or wholesale sales) of tobacco products was about \$272 million in FY 2013-14. Tobacco product wholesale cost has increased an average of about 8.7% per year over the past three years; therefore, the assumption is that wholesale costs will grow 8.7% per year without the proposed tax increase.

Based on previous tax increases, a tax rate increase as sizeable as proposed by this bill is likely to cause both a decrease in actual consumption and an increase in tax evasion of tobacco products; consequently, staff estimates sales of tobacco products will decline by a similar percentage as cigarette sales.

**Sales and Use Tax Impact.** Staff expects that all of the cigarette and tobacco products excise tax increases will be passed on to consumers. For both cigarettes and tobacco products, we added sales tax to the excise tax increase and subtracted from the excise tax increase the sales tax that would decline due to a decline in projected sales to determine net sales tax gains.

### Revenue Summary

FY 2015-16. Half-year revenues for the California Tobacco Tax Act of 2015 Fund are estimated to be \$665.2 million. These include floor stock tax revenues of \$85.6 million. Associated state and local sales and use tax revenues would be an additional \$18.7 million.

FY 2016-17. FY 2016-17 will be the first complete year of the measure's impact. The revenue impact is shown in the table below. For fiscal year 2016-17 the California Tobacco Tax Act of 2015 Fund created by this bill would receive \$1.29 billion from cigarette sales at the new tax rate. The tobacco products tax revenue and sales tax revenue impact are also shown in the bottom part of the table. Proposition 99 tobacco products revenues would increase by \$101.7 million, while Proposition 10 tobacco revenues would decrease by \$5.7 million due to reduced sales of tobacco products, resulting in a net increase of \$96 million for all tobacco products revenue. State and local sales and use tax revenue from both cigarettes and tobacco products combined would increase by \$38.8 million. In FY 2016-17, this measure would generate \$1.424 billion (\$1.29 billion + \$96.0 million + \$38.8 million) in total revenue.

### Revenue Impacts Summary

	Fiscal Year 2016-17 (Millions of Dollars)
<b>California Tobacco Tax Act of 2015 Fund</b>	<b>\$1,290.4</b>
Floor Stocks Tax (Not included in line above; paid in FY 2015-16)	\$85.6
Net Tobacco Tax Revenue Increase (Propositions 99 and 10; see bottom of table)	\$96.0
Total Net Increase (Cigarette Plus Tobacco Taxes)	\$1,386.4
<u>Sales and Use Tax:</u>	
State General Fund	\$19.3
State Education Protection Fund	\$0.6
Local Sales and Use Tax	\$14.5
Special Districts Tax	\$4.4
Total Sales and Use Taxes	\$38.8
Total Excise and Sales Taxes	1,425.2
<b>Associated Revenue Impacts on Other Tobacco Tax Revenues</b>	
<b>(Change from revenues under current law, millions of dollars)</b>	
Proposition 99	\$101.7
Proposition 10	-\$5.7
Total Impact	\$96.0

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Staff expects cigarette and related taxable sales revenues to decline in FY 2017-18 and future years for two reasons. First, tax-paid cigarette distribution would continue to decrease by about 3% per year. Without any other factors affecting revenue, related revenue also would weaken by about 3% per year. Second, the 0.25% State Education Protection Fund (sales tax) rate ends December 31, 2016, further reducing revenue associated with the sales and use tax.

With the exception of forecasting greater declines in tax-paid cigarette and tobacco distributions, this revenue estimate does not account for any further changes in economic activity that may or may not result from enactment of the proposed law.